The Office of Ratepayer Advocates'

Review of

The California High Cost Fund B:

A $500 Million Subsidy Program

For Telephone Companies

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PUBLIC VERSION

Information has been redacted from this report that may be considered proprietary or confidential by the utilities discussed herein.

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I. Executive Summary

The mission of the Office of Ratepayer Advocates (ORA) is to represent the interests of public utility consumers. This report was prepared by the staff of ORA in order to bring attention to a program that costs California's telephone customers close to $500 million a year, yet appears to fall short of achieving its goals.

ORA recommends that the California Public Utilities Commission (CPUC or Commission), in compliance with Decision (D.) 96-10-066, promptly commence a review of the program and give high priority to investigating the extent to which this program is achieving its stated goals. Consistent with D.96-10-066, this review should include an assessment of whether continued ratepayer funded subsidies are necessary and justified. [1]

This report reviews the seven-year old California High Cost Fund B (CHCF-B, Fund or program), seeks to assess its effectiveness in meeting its goals, identifies important issues that need further investigation and recommends alternatives for addressing the important concerns identified.

Summary of Findings:

- ✓ Carrier claims exceeded $463 million during the 2001 – 2002 fiscal year; over $100 million more than just six years ago. Overall claims have increased nearly 30% even though the per-line subsidy payments have not changed since the program's inception.
- ✓ The program does not require carriers to spend program subsidies on California's telecommunications networks.
- ✓ Carriers are not required to show they actually incur high costs in order to receive subsidies. The program gives hundreds of millions of dollars in subsidies to companies for costs they may not incur or for costs recovered elsewhere.
- ✓ The Fund pays subsidies to carriers even if carriers' profits exceed market-based rates of return.

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[1] Carriers who are eligible to receive subsidies from this program are SBC Pacific Bell, Verizon (formerly GTE California and Contel), Surewest (formerly Roseville) and Frontier (formerly Citizens), Cox Communications and MCI Worldcom. In this report we will refer to the carriers as Pacific, Verizon, Roseville, Citizens, Cox and MCI respectively.

- ✓ The program has not been reviewed as required, even though the CPUC ordered a review of the program funding be conducted three years after the 1996 decision which created it became effective.
- ✓ The program has largely failed to meet its objectives of encouraging competition for residential customers[2] or of expanding the availability of telephone service.
- ✓ The subsidies may actually impede development of local competition by providing incumbent carriers with funds that may be used to engage in anticompetitive behavior.
- ✓ Carriers are increasing rates that were previously reduced to offset subsidies from the CHCF-B while continuing to receive full subsidies from the Fund.

This report recommends prompt attention to examine the CHCF-B program, and offers recommendations for program reform. ORA believes that any universal service program which provides support to high cost areas must more effectively focus on preserving and increasing access to underserved areas.

ORA has previously asked the Commission to review the CHCF-B program needs.[3] However, the Commission did not act on ORA's request and subsequently closed the universal service proceeding. ORA issues this report as a way to renew its call for attention to the CHCF-B program in an effort to place a higher priority on investigating this approximately $500 million per year program. Local exchange competition has not developed as the CPUC anticipated when it established this program, and no cost-benefit analysis has been done to demonstrate that Californians receive value from this increasingly costly program.

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[2] "The CHCF-B that we adopt is appropriately sized to encourage competition in all markets, while at the same time preserving and promoting universal service throughout the state.", D.96-10-066 (mimeo), pg. 111.

[3] Motion Of The Office Of Ratepayer Advocates For A Ruling Requiring Expedited Review Of The Cost Proxy Model Results, September 19, 2000.

II. Background

A. Genesis of CHCF-A and CHCF-B

Independent telephone companies (ITCs) historically relied on long distance revenues to help finance their local operations. After the break up of AT&T and the introduction of competition in the long distance market, ITCs depended on access charge revenues.[4] When the Commission undertook access charge reform, ITCs faced dramatically diminishing revenues. The Commission, in Decision (D.) 85-06-115, addressed this concern by establishing the California High Cost Fund (CHCF), a program of transfer payments from Pacific Bell to the ITCs.

In 1989, the Commission adopted the New Regulatory Framework (NRF) for Pacific and Verizon. The NRF was intended to permit these carriers greater regulatory pricing flexibility in offering services facing varying degrees of competition. During the Implementation Rate Design (IRD) phase of NRF, rates for the then-NRF incumbent local exchange carriers (ILECs) Pacific and Verizon were rebalanced.

In the IRD proceeding, the Commission reduced the rates for many services for which competition was authorized, such as intraLATA toll, moving the prices of those services closer to the LECs' reported costs, while an effort was made to keep basic local exchange service "affordable." However, in rebalancing rates, the Commission adopted the NRF LECs' proposal that, for purposes of measuring costs, local exchange service should bear all "non traffic sensitive" (NTS) costs.[5] This permitted NRF LECs to price their intraLATA toll services at prices considered "competitive." However, it also meant that the cost of local exchange service was deemed higher than would be the case if NTS costs were spread among all services and that local exchange rates were priced "below cost".[6] Although the rate for local exchange service was considered to be below cost, the shortfall was recovered through revenues from other services that were priced above cost.

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[4] Long distance carriers pay access charges to compensate local exchange companies for connecting calls to/from interexchange carrier networks from/to the local exchange carrier's customers.

[5] D.94-09-065, p.44.

[6] Costs of plant used jointly for two or more services have historically been allocated according to the "actual use" principle. (Phillips, Charles F., *The Regulation of Public Utilities*, (Public Utility Reports, 1988), page 216)

When local exchange competition was contemplated, the Commission was again faced with the dilemma of how to ensure universal availability of telephone service that purportedly relied on cross subsidies between competitive and non-competitive services. However, in addition to the earlier crisis faced by ITCs with diminishing toll and access charges from long distance carriers, the newer problem resulted from differences in the cost of local service between low cost, high density urban areas and high cost, low density rural areas within the NRF LECs' own service areas.

Originally, Public Utilities Code Section 739.3 required the Commission to develop, implement, and maintain a suitable program to establish a fair and equitable local rate structure aided by transfer payments to small independent companies serving rural and small metropolitan areas. In 1994, the Legislature passed AB 3643, which required the Commission to examine the current and future definitions of universal service, including how universal service should work in the new and expected increasingly competitive markets. Then, in September 1996, the Legislature passed SB 207, which amended PU Code Section 739.3 to develop a competitively neutral, broad-based program to help ensure that telephone service is widely available and affordable under local competition, and required the Commission to report on the effectiveness of its universal service programs. The stated purpose of the program was to promote the goals of universal telephone service and to reduce any disparity in the rates charged by telephone companies.

As part of the "road map" leading to the introduction of local exchange competition, the Commission, in its examination of the universal service funding programs, created a new program to address this issue. The Commission adopted D.96-10-066, which established the California High Cost Fund B (CHCF-B) program for the four NRF telecommunications carriers in accordance with PU Code 739.3. To distinguish this new program from the existing CHCF program, which provided support to small, cost-of-service ITCs, the Commission renamed the existing CHCF program the "CHCF-A", and called the new program the "CHCF-B."

The CHCF-B program was created to allow new market entrants access to universal service funds for providing residential local exchange service to areas where, NRF price cap regulated telephone companies allege, the cost of providing service exceeds the rates charged to customers.[7] The new program required the Commission to first "extract" implicit subsidies supporting basic

[7] D.95-07-050, p.34.

local exchange service, replace these subsidies with funds provided by the CHCF-B and make them available to all eligible carriers.

When the Commission initially established the CHCF-B Fund of $352 million, it ordered reductions in certain ILEC rates (excluding rates for residential basic service) by the same amount to offset the subsidies carriers would now receive from the Fund instead of through rates. This was done to prevent a "windfall" to carriers that would now be receiving subsidies from the CHCF-B fund while retaining revenues from the implicit subsidies that were built into rates for services priced above cost to help offset the cost of providing universal service.[8]

The Commission was aware that incumbent carriers might seek to selectively reduce rates for services facing competition as a way to forestall market share loss, while keeping rates high for services not facing competition.[9] The Commission ordered that rates be reduced by an equal percentage "across the board" to minimize controversy over selective rate reductions.[10] The Commission further allowed the ILECs to file applications to target the reductions to specific services. Pacific was the only ILEC to avail itself of this option.[11]

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[8] D.96-10-066, p. 4.

[9] Ibid, p.207.

[10] Rate reductions for Pacific were ordered in D.98-07-033. They included a 29% reduction in MTS toll for both business and residential, an approximately 36% reduction in switched access rates, and a $7.1 million total revenue reduction applied to rates for single custom calling features (except Centrex) for both business and residential. There were also reductions in local usage/ZUM charges (11.9%) and business ZUM rates. (p. 39)

The implementation of permanent rate reductions for Citizens (now Frontier), GTE/Contel (now Verizon), and Roseville (now SureWest) to offset their CHCF-B draws was ordered in D. 98-09-039. Each company was ordered to reduce all of its rates, except for residential basic service, contracts, and coin-sent pay calls, by an equal percentage; and each company was ordered to file an Advice Letter to implement these surcredits. (Id., p. 29) In that same decision, the Commission permitted these companies to file applications within 24 months to reduce their rates and price ceilings by an amount equal to their actual CHCF-B draws, apparently as a replacement for the permanent surcredits. (Id., p. 32.) It appears that none of these companies ever filed such an application.

[11] Roseville implemented the surcredit via Resolution T-16237; Citizens via T-16239; and Verizon (GTEC) via T-16238.

B. Commission action.

The Commission concluded that, in an era of local competition, the ILECs could no longer rely on internal subsidies from low cost areas and services to promote universal service in high cost local exchange areas.

The CPUC took the following steps to establish the CHCF-B[12]:

1) Decide which service elements constituted "residential basic service."[13]
2) Estimate the total cost of providing residential basic service to the entire state.[14]
3) Choose the "benchmark" or cut-off point for designating an area as "high cost."[15]
4) Determine which sources of revenue should be used to offset subsidies.[16]
5) Determine the funding mechanism to be used.[17]
6) Determine who should contribute to the Fund.[18]

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12 D.96-10-066, p. 93.

13 The CPUC determined that residential basic service must provide seventeen elements, including access to single party service, unlimited incoming calls, free access to 911, choice of flat or measured rate service, access to directory assistance and a free white pages telephone directory, among other things. (D.96-10-066, Appendix B, Rule 4.B)

14 The total costs do not include costs for providing telephone service in the territories of the smaller ILECs, nor do they consider the cost of serving unserved territories. "Unserved areas generally remain unserved because of the high costs of serving them. Many of these unserved territories would be best characterized as 'extremely high cost' territories." (D.96-10-066, P.55)

15 The CPUC established census block groups (CBGs) as the geographic serving area, and used Pacific's Cost Proxy Model (CPM), with adjustments, to estimate total and per line statewide costs and per line costs for each CBG. The CPUC then decided that the statewide average cost of $20.30 would be used as the benchmark (D.96-10-066, p.166). A CBG with an estimated per line cost exceeding the statewide average is designated as "high cost" and yields a subsidy to carriers of last resort (COLRs) for each primary line served in the CBG. All of the NRF ILECs were designated as COLRs. Competitive local exchange carriers could use a simple process to apply for COLR status.

16 "Offsets" to estimated CBG costs include revenue from the incumbent carrier's flat rate service, the end user common line (EUCL) charge, and revenues per subsidized line from the carrier common line charge (CCLC) and the federal universal service fund (USF). D.96-10-066, Appendix B, Rule 6.C.2

17 An "all end user surcharge" (AEUS) is used to fund the CHCF-B (D.96-10-066, p.185).

18 Universal Lifeline Telephone Service (ULTS) billings, coin-sent paid calls, debit cards messages, one-way radio paging, customer-owned pay telephone (COPT) usage charges, directory advertising and pre-

7) Develop the surcharge to fund the program.[19]

8) Determine which ILEC rates should be reduced as a result of replacing "built in" subsidies with an explicit external subsidy program.[20]

III. Program Objectives

The introduction of competition in the local exchange market required a change in the then existing mechanism for achieving the state's universal service goals. Until 1996, under the cost allocation structure adopted by the CPUC (where the non-traffic sensitive costs were assigned to local service), basic telephone service rates had been subsidized by rates charged for other telephone services. In addition, the cost to provide basic telephone service varied widely across the state – less in urban areas, more in rural areas. To fulfill the universal service goals of widely available and affordable service, and consistent with P.U. Code Section 453 (c), rate averaging was employed. Rate averaging resulted in lower cost areas subsidizing higher cost areas to keep rates uniform across each company's service territory.

The objectives of the CHCF-B program were to promote the goals of universal telephone service and reduce rate disparity, while encouraging competition (or at least not discouraging it).21 By making what had been intrinsic subsidies explicit, the program was intended to provide a competitively neutral funding mechanism that applied to all service providers in the NRF LECs service territories. This mechanism was expected to remove previous barriers to the advent of local competition and to reduce rate disparity within each company's service territory.

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existing customer contracts executed on or before September 15, 1994 are exempted from contributing to the CHCF-B Fund. D.96-10-066, p.191.

[19] Initially, a 2.87% surcharge was established to fund $352 million per year in subsidies. D.96-10-066, Appendix D.

[20] The CPUC reduced some Pacific rates in D.98-07-033.

[21] D.96-10-066, p. 626.

IV. Program Budget and Methods – How the CHCF-B works

A. Which carriers receive subsidies?

1. *Carrier of Last Resort (COLR) Requirement*

The CHCF-B subsidies are only available to service providers designated as "carriers of last resort" (COLRs) operating in the territories of price cap regulated ILECs operating under the New Regulatory Framework (NRF).[22] A COLR must serve all residential and business customers who request service in all areas in which the carrier is designated a COLR.[23]

Commission rules limit the availability of subsidies to only one residential line per household. The Commission identified this line as the "primary line" (i.e., the first line to a household).[24] COLRs may claim a subsidy for each residential "primary" line served in designated high cost areas. COLRs need not provide current cost support to confirm that the carrier in fact incurs high costs or to otherwise justify the claimed subsidy.

There are currently two competitive local exchange carriers (CLECs) that are designated as COLRs: Cox California Telcom (Cox) and MCI. Of those, only Cox has drawn subsidies from CHCF-B.

2. *List of carriers*

1. *Share of CHCF-B funds each receives*

Table 1 lists the COLRs and shows that Pacific and Verizon are by far the largest recipients of subsidies.

[22] The NRF carriers, all COLRs, are Pacific, Verizon, Citizens Telephone Company and Roseville Telephone Company.

[23] D.95-07-050 and D.96-10-066, Appendix B, Rule 1.F.

[24] D.96-10-066, p.128.

Table 1. Share of CHCF-B Initial Subsidy Claims by Local Carrier for fiscal year 2001 - 2002[25]

Local Carrier	Subsidy Share (%)	Subsidy Amount
Pacific	[redacted]	[redacted]
Verizon (formerly Contel California)	[redacted]	[redacted]
Verizon (formerly GTE California)	[redacted]	[redacted]
Cox Communications	[redacted]	[redacted]
Citizens	[redacted]	[redacted]
Roseville	[redacted]	[redacted]
MCI	[redacted]	[redacted]
Total		**$ 463,591,746**

Although Roseville and Citizens account for a small percentage of the dollars, the CHCF-B is relatively more important to them, based on the proportion of subsidized lines in their service areas. At program inception, the lines of most customers of Citizens and Roseville were located in areas designated as “high cost”, while most of Verizon and Pacific lines were not.

Table 2. Estimated Subsidized Lines by Local Carrier at Program Inception[26]

Local Carrier	Number of Subsidized Lines	Subsidized lines as % of each carrier’s total lines
Citizens	42,649	71%
Roseville	40,199	59%
Verizon (formerly GTE California)	1,048,508	39%
Verizon (formerly Contel)	224,556	81%
Pacific	2,671,814	28%
Total	**4,027,727**	

B. How subsidy is determined

Commission decision (D.)96-10-066 implemented the CHCF-B. A substantial portion of that decision addressed high cost areas, and in particular the technical details of defining and assigning costs to these areas using a complex model; the Cost Proxy Model (CPM). When the CHCF-B was

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25 Source: CPUC, Telecommunications Division Records.

26 D. 96-10-066, Appendix D.

established, subsidies were determined by 1) estimating the total cost of providing basic service for all residential access lines in the NRF territories[27], 2) estimating the cost per residential access line for individual geographic areas[28], and 3) picking a cut-off point for deciding when an area was "high cost." The CPUC decided that Census Block Groups (CBGs) with an average per line cost greater than the statewide average cost were "high cost."[29] In 1996, the statewide average cost per access line was estimated to be $20.30, based on the CPM.[30] The CBG-based approach is merely one of many possible ways to allocate subsidies to carriers.

In a given high cost CBG, a COLR's's subsidy is computed by taking the difference between the proxy cost for that CBG and the carrier's tariff rate plus the End User Common Line (EUCL) charge for interstate access for each primary access line that carrier serves in that CBG. Any revenues the carrier receives from the federal Universal Service Fund (USF) are subtracted from its CHCF-B claim.

Neither the proxy costs for each CBG nor the statewide average cost have been changed since 1996. Both are based on data that is ten years old.[31]

Table 3 shows the distribution of high cost CBGs.

[27] D.96-10-066, p.124.

[28] The CPUC selected census block groups (CBGs) as the geographic unit for this purpose. D.95-12-021, pp.10-11.

[29] D.96-10-066, Finding of Fact 152.

[30] D.96-10-066 adopted an adjusted Cost Proxy Model (CPM) sponsored by Pacific Bell. Each Census Block Group (CBG) was given a proxy cost based on 1994 costs. The decision then derived a statewide average cost of $20.30 and set that as the threshold for designating a CBG as a high cost area.

[31] The cost data is from 1994.

Table 3: Distribution of high cost areas[32]

Computed proxy cost ($ per line per month)	# of Census Block Groups	% of Census Block Groups
$20-$25	4641	61%
$25.01 - $30	1311	17
$30.01 to $35	563	7
$35.01 to $40	373	5
$40.01 to $45	241	3
$45.01 to $50	158	2
$50.01 to $100	286	4
$100.01 to $200	16	0.2
Over $200	4	0.1
Total	**7593**	

Most of the "high cost" areas are near the lower threshold of high cost. While the subsidy for these lines will be relatively small, even a small decrease in the estimated cost can have a significant effect on program outlays due to the great number of lines whose estimated cost is just above the current high cost benchmark.

C. The CHCF-B Surcharge

The forecasted annual carrier claims are divided by the total intrastate billings to come up with the surcharge percentage. The surcharge is expressed as a percentage and is recalculated every year.

With the exception of Universal Lifeline Telephone Service (ULTS) customers, virtually all other telecommunications customers pay the CHCF-B surcharge.[33]

Table 4 shows the history of surcharge rates paid by customers:

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[32] Analysis done from data posted on CPUC website: See http://www.cpuc.ca.gov/static/industry/telco/public+programs/chcfb.htm

[33] Universal Lifeline Telephone Service (ULTS) billings, coin-sent paid calls, debit cards messages, one-way radio paging, customer-owned pay telephone (COPT) usage charges, directory advertising and pre-existing customer contracts executed on or before September 15, 1994 are exempted from contributing to the CHCF-B Fund. D.96-10-066, pp.190 - 191.

Table 4: CHCF-B Surcharges[34]

Effective date	CHCF-B surcharge
7/1/2003	2.700%
3/1/2003	2.200%
7/1/2002	1.420%
11/1/2001	1.470%
1/1/2000	2.600%
1/1/1999	3.800%
2/1/1997	2.870%

D. *Fund size*

At Fund inception in January 1997, the CHCF-B was to provide $352 million per year in carrier subsidies. By fiscal year 2001-2002, the budgeted subsidy had grown to nearly $500 million.[35] The budgeted subsidy amount increased 40% over five years, and carrier initial subsidy claims increased by nearly 30% in the same period. During this time, California's population grew by a total of 9%.[36]

Table 5 shows the **budgeted** subsidy amounts. It should be noted that this varies from what carriers actually claim, and from what is approved and actually paid out..

[34] From CPUC website: http://www.cpuc.ca.gov/static/industry/telco/consumer+information/surcharges+and+taxes/index.htm

[35] CPUC Resolution T-16585, issued October 10, 2001.

[36] California Department of Finance, Statistical Digest, http://www.dof.ca.gov/HTML/FS_DATA/stat-abs/sec_B.htm. The period used is 1996-2001.

Table 5: CHCF-B Budget

Year	Budgeted Amount
FY 2003 -2004	$483,178,000
Revised FY 2002 - 2003	$471,372,000
FY 2002 -2003	$535,018,000
Revised FY 2001 – 2002	$972,872,000 *
2001 – 2002 fiscal year	$482,767000
2001 first six months	$253,569,000
2000	$502,801,000
1999	$446,146,000
1998	$411,000,000
1997	$352,800,000

* Includes $411,000,000 in carry over claims from previous years and $15,000,000 loan to the Deaf and Disabled Telecommunications Program (DDTP).

Table 6 shows a summary of CHCF-B claims for the corresponding periods.[37]:

Table 6: Initial claims by carriers

Year	Amount
2001 – 2002 fiscal year	$ 463,591,747
2001 first six months	$ 224,211,223
2000	$ 419,462,369
1999	$ 430,896,595
1998	$ 376,668,567
1997	$ 323,017,467

E. Program review

When the program was established in 1996, the CPUC ordered that a review of the program be conducted every three years.[38] To date, no reviews have been conducted and the Commission closed the proceeding in 2002.[39] In the meantime, technology in the telecommunications industry continues to improve and costs per access line served have changed, and probably declined. However, the CHCF-B subsidies are based on cost information compiled prior to 1996, and do not represent the current actual costs of providing service.

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37 Data based on initial carrier claim amounts, contained in CPUC Telecommunication's Division records. Actual approved payment amounts may be different. Frequently, initial claims are revised as well. This data does not take any subsequent revisions into account.

38 D.96-10-066, Appendix B, Rule 6.C.4.

39 D.02-10-011.

V. ORA Evaluation of the CHCF-B

A. The CHCF-B appears to have failed to encourage local competition for residential subscribers in high cost areas.

The Commission reported recently that the ILECs control 94% of the statewide local residential market, as measured by access line data, compared to the CLECs' 6%.[40] Although no information is available on the number of residential customers living in designated high cost areas served by competitive carriers, few CLECs have sought to participate in the program.

The Commission requires that CHCF-B subsidy recipients be designated as "carriers of last resort" (COLRs). The purpose of allowing only designated COLRs to receive subsidies "*is to attract competition into these high cost areas.*"[41] Based on the lack of competition in the residential local exchange market generally and competitive carriers' apparent lack of interest in participating in the CHCF-B program, it appears that competition for residential local exchange customers has to date failed to materialize in any substantial way in high cost areas, particularly in non-urban residential markets.

Since the program's inception, only two competitive local exchange carriers (CLECs) have become designated COLRs, Cox in 1999 and MCI in 2003. At the time it became a COLR, Cox affiliates already had networks in place providing cable television service to primarily residential customers, and Cox was already offering local exchange telephone service to residential customers over its affiliate's cable networks in the areas where it was initially designated a COLR.[42] Thus, the CHCF-B program did not attract Cox to serve high cost areas, because the carrier was already operating in designated high cost areas without subsidization. Recently, MCI obtained the COLR designation.

Eight years after the authorization of local exchange competition, except for the two carriers noted above, incumbent local exchange carriers (ILECs)

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[40] "The Status of Telecommunications Competition in California: Third Report for the Year 2003", October 31, 2003, p 16.

[41] D.96-10-066, p. 199.

[42] Cox Advice Letter No. 38 seeking COLR designation, filed October 29, 1999. Cox became a COLR effective December 8, 1999.

continue to be the only COLRs serving residential subscribers in areas designated as "high cost." Therefore, ORA contends that the program has largely failed to meet its objective of attracting competitive options for residential customers in designated high cost areas.

B. *Unwarranted subsidies may actually be impeding competition by providing carriers with funds that can be used to engage in anticompetitive behavior.*

When the CHCF-B was established, the Commission recognized the potential of the program to undermine competition, if the subsidies received were greater than a carrier's costs.[43] As discussed above, ORA is concerned that the subsidies provided by the CHCF-B may exceed what is actually needed to supplement revenues to cover the actual costs of providing service in the NRF ILECs' territories.

Thus, these excessive subsidies may be available to carriers for activities like cross subsidizing competitive services, financing unregulated ventures and for potentially engaging in anticompetitive conduct. The extent to which these activities may be occurring is unknown, because the Commission has not examined either the functioning or efficacy of the program.

However, data indicates that competition for residential customers remains feeble at best.[44] ORA is concerned that, contrary to promoting the development of competition for residential customers, the subsidies provided by the CHCF-B almost exclusively to the four largest incumbent carriers (and primarily to Pacific) may be a contributing factor to the slower than expected development of local exchange competition.

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[43] "If the fund is oversized, the subsidy provided to carriers will exceed the actual cost of subsidizing residential basic service in high cost areas, and allow the recipients of such funds to cross subsidize other services, and to engage in other anticompetitive behavior." D.96-10-066, Finding of Fact No. 86.

[44] The CPUC's Third Competition report found that "…ILECs continue to control the local wireline market in California, although CLECs are gaining ground in the local toll market. SBC continues to lead the local and local toll marketplaces, earning more than all CLECs combined." The Status Of Telecommunications Competition In California", Third Report, October 31, 2003, p.5.

C. Universal Service issues.

1. *It is unknown whether, or to what extent, the CHCF-B contributes to the availability and affordability of basic phone service in California.*

In 1994, the Legislature passed AB 3643, which stated, in Section 1(a),

> The longstanding cornerstone of state and federal telecommunications policy is universal service, which requires that telephone service be affordable and ubiquitously available.

The CHCF-B addresses both the affordability and the availability of telephone service in designated high cost areas. A key goal of the CHCF-B program is to ensure universal access in rural and high-cost areas at rates that are comparable than those paid by urban customers in high-density lower cost areas. When the Commission restructured telephone pricing for Pacific and Verizon in the mid-'90s, certain previously implicit subsidies were made explicit and transparent. A major goal of this was to ensure the continuance of basic service at affordable rates for all as competition developed.

The Commission's rules establish that one of the factors it considers in evaluating the fitness of a carrier seeking to become a COLR eligible for CHCF-B subsidies is the carrier's "*ability…to promote the goals of universal service to all customer segments throughout the COLR's service area.*"[45] However laudable the Commission's goal, it does not assure that all customers in COLR territories can obtain affordable telephone service, or even obtain telephone service at all.

In evaluating the program's progress in promoting universal access, ORA uses as a benchmark the Commission's objective of 95% subscribership for all ethnic customer groups.[46] The Federal Communications Commission (FCC) recently released its telephone subscribership statistics, reporting California's 96.8% penetration rate as ranking eleventh out of the fifty states.[47]

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[45] D.96-10-066, Appendix B, Rule 6.D.4.b. The Commission originally proposed that one of the factors it would consider in evaluating carriers' COLR requests would be the carrier's *"ability…to promote the goals of universal service in low income and non-English speaking communities."* However, this proposed rule was deleted and broadened to promote universal service among all customer segments. (D.96-10-066, p.202)

[46] The 95% goal was first set forth in D.94-09-065.

[47] Trends in Telephone Service, FCC, August 2003, Table 16.2. Telephone Penetration By State, (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/trend803.pdf)

Those who still do not have telephone service are primarily from economically disadvantaged populations – rural, minority, low income, and non- or limited-English speaking communities.

ORA found very little correlation between subsidizing telephone lines in high cost CBGs and increasing the subscribership levels of underserved communities whose telephone penetration rates fall short of the 95% universal service goal. It is unknown whether, or to what extent, the CHCF-B subsidies increase universal access to telephone service for those who currently do not have access.

However, even though the CHCF-B has been in existence almost 7 years, the CPUC has not undertaken an assessment of the program's effectiveness in promoting universal access, despite its stated intention to do so after the first three years of the program. [48]

2. Barriers to the provision of affordable telephone service

Despite the Commission's explicit requirement that a COLR must "*stand ready to provide basic service to any customer requesting such service within a specified area*",[49] COLRs can and do, through their tariffs and in other ways, substantially limit, and in some cases entirely eliminate, their obligations to serve all qualified applicants requesting service.

This is because COLR tariffs contain provisions that expressly limit the availability of basic service or service elements with a phrase like "…*available where facilities and operating conditions permit*." For example, Verizon's tariff provides that *"Exchange service is available…where operating conditions and facilities permit…*" and that "*The Utility is not obligated to provide service except under reasonable conditions.*"[50] Pacific's local exchange tariff provides that residential basic service will *only* be provided to new applicants in certain communities "…*if facilities are available*", [51] even though it receives CHCF-B subsidies as a COLR for

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[48] "The review of the CHCF-B funding mechanism will ensure that the overall size of the fund is within reason, and that it will be adjusted as competition and technology evolve. By conducting such a review, the need for ongoing high cost area support may be reduced over time. The CHCF-B surcharge should also be recalculated each year to account for changes in the billing base. Due to the entry of new competitors, and the use of this untested CHCF-B fund mechanism, a review of the fund should take place in three years." (D.96-10-066, p 214)

[49] D.96-10-066, Appendix B, Rule 1.G.

[50] See Schedule CAL. P.U.C. No. D&R, Rule No. 1.A.

[51] See Schedule CAL. P.U.C. No. A5.2.1.A.3 and A5.2.2.A.3.

"[*standing] ready to serve* *any* *customer requesting service*" in these same designated high cost areas.

Importantly, carrier tariffs usually provide for "line extension" charges[52] and other additional charges for serving customers under certain conditions.[53] Thus, even those living in areas where carriers are receiving CHCF-B subsidies may not be able to obtain service, or can be required to pay additional charges. As a result, COLRs are not actually obligated to meet every request for service, and additional charges may still make basic service unaffordable in some locations.

D. CBGs defined as "high cost" may be overly inclusive.

The most recent Commission report on universal service describes the CHCF-B as providing subsidies to carriers that "...provide service in high cost rural areas."[54] CBGs designated as high cost are spread over the entire state, and in 57 of California's 58 counties, including densely populated counties.[55] The lone exception is Del Norte County, which is served by a small telecommunications company; small companies are subsidized by the CHCF-A.

Given this level of dispersion, it is difficult to characterize the geography of the high cost CBG. However, many could be described as suburban in nature. For example, in Santa Clara County, the city centers of Santa Clara and San Jose are not designated as high cost areas. However, as one goes further away from the city center, there are an increasing number of areas designated as "high cost." Moreover, at the western boundary of the county, the level of subsidy increases for areas like Monte Sereno. This scenario is repeated in other suburban areas across the state. Much of the current and likely future population growth has been in areas near cities that have been built up or have experienced rapid growth. Orange, San Diego (North County), Riverside, and Placer are good examples of this trend.

The ubiquity of CHCF-B designated areas suggests a definition of "high cost" that may be over-inclusive. While the CHCF-B designates low-density

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[52] See, for example, Pacific Schedule CAL. P.U.C. No. A2.1.15, and A4.3.

[53] See, for example, Pacific Schedule CAL. P.U.C. No. A2.1.3.D.1.

[54] CPUC, Broadband Services as a Component of Basic Phone Services, August 2002, p.13.

[55] See Volume 2 of California High Cost Fund B High Cost Census Block Groups, (CPUC, Telecommunications Division, September 8, 1998) which contains maps.

rural areas as high cost, it also appears to include communities with large residential lots, and relatively lower line density. The Commission's 1996 decision ordered a review of the program and the subsidies every three years.[56] Despite this mandate, neither the program nor the subsidies have ever been reviewed. The Commission found that vigilance is required to ensure the CHCF-B is neither oversized nor undersized, noting that if the fund is oversized, "the subsidy provided to carriers will exceed the actual cost of subsidizing residential basic service in high cost areas, and allow the recipients of such funds to cross subsidize other services, and engage in other anti-competitive behavior.[57]

E. Lack of program review may be resulting in excessive CHCF-B subsidies.

1. *Outdated cost information –Telecommunications is generally a declining cost industry. The CHCF- B program is based on 1996 cost estimates that used 1994 data. Program subsidies are based on proxy cost estimates that may now exceed actual cost of residential service.*

When the CHCF-B was initiated in 1996, the Commission estimated that just over 4 million lines would be eligible for subsidy.[58] Because the per-line subsidy payments have not changed since the program's inception, ORA believes the increase in subsidy payments are likely a result of an increasing number of residential access lines in designated high cost areas.

The program may give millions of dollars in subsidies to companies for costs the companies don't incur.

The dollars claimed by carriers have increased nearly 30% since the program began, even though the per-line subsidy payments have not changed since the program's inception. This represents an increase of over $100 million more per year than when the program began six years ago. Carrier claims are estimated to be $476 million during the 2003-2004 fiscal year (a $7 million increase over the 2002-2003 fiscal year), and customers now pay a surcharge of 2.7% on their telephone bills to fund the program.[59]

[56] D.96-10-066, Appendix B, Rule 6.C.4.

[57] D.96-10-066, Finding of Fact 85 and 86.

[58] D.96-10-066, Appendix D.

[59] Resolution T-16690.

The subsidy level is a function of the number of lines in each high cost CBG, the number of high cost CBGs, and the extent to which their average cost exceeds the authorized statewide average cost.

ORA is concerned that the current statewide average cost for residential basic service may be substantially below the estimate adopted in 1996. ORA is also concerned that current costs for residential access lines in CBGs designated as "high cost" may also be substantially below the levels estimated in 1996. Thus, ORA contends that the CHCF-B program may be providing excessive and unnecessary subsidies to carriers, at the expense of California's ratepayers.

NRF carriers establish "price floors" for Category II services, which are services deemed to be facing varying degrees of competition. These price floors are based on the carriers' estimated cost for providing a particular service. ORA has reviewed the residential flat rate service price floor/cost information filed by Pacific[60] and Verizon.[61] These carriers' inflation-adjusted average costs for this service are currently substantially below the average costs upon which CHCF-B subsidies are based. For example, Pacific's price floor for residential flat service is [redacted] and Verizon's is [redacted]. Nevertheless, these carriers and other CHCF-B program COLRs are paid subsidies based on an average cost of $20.30,which was set in 1996 using 1994 data.

The CHCF-B does not require carriers to show that they actually incur "high costs" to justify the subsidies received. Nor does the program have a mechanism that adjusts subsidy payments according to current cost information available to the CPUC. As a result, the program continues to pay subsidies based on costs estimated in 1996 while carriers may actually incur far lower costs. Thus, some of the CHCF-B subsidies currently paid may well be an unwarranted windfall to carriers provided by California's ratepayers.

In 2000, ORA filed a motion with the Commission to recalculate CHCF-B funding using current data in the Commission's Universal Service proceeding (R.95-01-020), [62] and estimated that the magnitude of low cost areas classified as High Cost resulted in excess program costs for Pacific of $50 to

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[60] Pacific 2003 Price Floors filed January 24, 2003. Designated "proprietary"

[61] Verizon AL 10479, filed April 4, 2003. Designated "proprietary"

[62] Motion Of The Office Of Ratepayer Advocates For A Ruling Requiring Expedited Review Of The Cost Proxy Model Results, September 19, 2000.

$75 million per year based on ORA's analysis. Each passing week results in the likely excess subsidy of at least $1 million (and growing) to carriers.

2. *Effect of increased population density in "high cost" areas*

Population density is one of the most important factors affecting average cost of telephone service. Generally, the greater the number of access lines in a geographic area, the lower the cost per line to serve the area. Many of the areas designated as "high cost" have experienced substantial population (and, therefore, access line) growth in recent years.

Table 7 shows several California counties that have experienced substantial population growth.

Table 7. Population Change from 1990 to 2000 for some California counties with numerous "high cost" CBGs.

County	Growth	% Change
Los Angeles	656, 174	7.4
Orange	435,733	18.1
Riverside	374,974	32.0
San Diego	315,817	12.6
San Bernardino	291,054	20.5
Santa Clara	185,008	12.4
Sacramento	182,280	17.5
Alameda	164,559	12.9
Contra Costa	145,084	18.1
Fresno	131,917	19.8
Kern	118,168	21.7
Ventura	84,181	12.6
San Joaquin	82,970	17.3
Stanislaus	76,475	20.6
Placer	75,603	43.8

Source: U.S. Census Bureau

It is likely that many of the designated "high cost" areas within these and other counties have also experienced substantial population growth. ORA contends that, all other things being equal, population growth in high cost areas will drive down the cost of service, making previously high cost areas now likely to be lower cost.

In addition to the effect of driving down the average cost per access line, substantial population growth in high cost areas has another consequence that calls for immediate attention. Because a fixed per line subsidy amount is paid to carriers for each primary residential access line in eligible areas, population growth in these areas permits carriers to make larger and larger subsidy claims for areas where costs may be actually declining. Ironically, as carriers' real costs may be declining, their claims on the Fund may increase.

F. Validity of cost proxy model (CPM)

The CPM – the cost model adopted by the Commission -- was a proxy cost model. In other words, it did not *directly* compute the cost of serving each area, but rather used variables regarded to be major cost drivers to *estimate* the cost for each area. The adopted cost proxy model (CPM) was run in 1996, using 1994 data. It generated proxy costs for each CBG, as well as a statewide average cost of $20.30, to be used as the cut-off point in determining which CBGs were to be considered high cost.

Questions have been raised about the overall validity of the CPM. Previously, ORA analyzed Pacific's census block group data on a geographic basis in I-00-03-002.[63] ORA preliminary analysis suggested that two-thirds of the "high cost" CBGs are located in wire centers[64] which appear to have lower loop costs.[65] Essentially this means that "high cost" areas can be right in the middle of a portion of a local carrier service territory that has a low cost of service. This is consistent with the criticisms of the CPM made during its initial review.[66] Further complicating the Commission's ability to evaluate the model, advances in technology have rendered the CPM obsolete.

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[63] Cited in September 19, 2000 motion above.

[64] A building or space within a building that serves as an aggregation point on a given carrier's network, where transmission facilities are connected or switched. Wire Center can also denote a building where one or more Central Offices, used for the provision of Basic Exchange Telecommunications Services and Access Services, are located.

[65] The local loop is the physical connection between the subscriber's premise to the carrier's central office or other point of presence. The local loop typically runs from the demarcation point, often the network interface device (NID) on the side of the house for residential users, or the phone room in the basement or garage in multiple living units, to the carrier's central office. The local loop's medium may be twisted copper pair, fiber optic, hybrid fiber-copper, or coaxial cable.

[66] D.96-10-066, p.118.

The Commission never intended for the CPM proxy costs to remain the basis of the subsidy calculation forever. It was hoped that by the time that the initial three year review rolled around, that workable local competition would have taken hold, and that an auction mechanism could be used to review the subsidy amounts in the future, thus avoiding time consuming, contentious and expensive cost studies. "A properly structured auction mechanism could drive down the cost of the subsidy for high cost areas if a more efficient provider exists in a particular Geographic Study Area (GSA)."[67] The Commission further noted that " if little or no competition develops, then we may reconsider whether the use of an auction mechanism is appropriate for reviewing the subsidy amounts."[68]

However, as noted above, local competition has failed to materialize in any widespread or substantial way, particularly for residential customers. The Legislative Analyst reported that "the PUC states that a lack of interested bidders precludes using an auction to determine an appropriate subsidy amount to provide basic telephone service in high-cost areas. … The PUC indicates that it will monitor these auction issues in the triennial review of universal service programs. Currently, in the absence of an auction, PUC determines the companies' costs of service and sets subsidy amounts accordingly."[69]

However, the Commission has not updated either the proxy costs or statewide benchmark since first calculating them in 1996. If costs have actually decreased, then carriers are being over-subsidized – at ratepayer expense. A comprehensive review of these subsidy amounts is long overdue. The Commission hoped that the need for ongoing high cost area support would be reduced over time as competition increased. Instead, we have a situation where subsidy payments are increasing, possibly without a corresponding increase in competitive basic telephone service options for residential customers.

Additionally, the CPM is no longer supported, and is unavailable to perform even minimal updates. The Commission should consider using the FCC high cost model or other more up-to-date and direct methods of calculating the cost of residential basic service.

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[67] D.96-10-066, p. 215.

[68] D.96-10-066, p. 216.

[69] Analysis of the 2001-2002 Budget Bill, Public Utillities Commission (8660), by Legislative Analyst's Office.

In 1996, when the Commission adopted the model, the current methodology now used to calculate the costs of unbundled network elements (UNEs) was not yet in use. The discontinuity between the CPM and the more direct calculation of network costs underscores the need to review and validate the costing method or to select a different approach. As the 1996 decision noted, the CPM selected was derived from multiple, complex models, highly reliant upon Pacific data, and not readily verifiable.[70] The Commission also adopted numerous adjustments to the model, reducing the original cost estimates computed by the model by over 60% of the original estimated cost.[71]

ORA urges the Commission to investigate the feasibility of using UNE costs to determine, at least on an interim basis, the cost of serving high cost areas. Generally, the CHCF-B program needs a more robust approach. A model that was originally flawed and substantially adjusted, and that now has become obsolete before it was even run a second time is not robust. It does not allow for ongoing course corrections – an important part of any subsidy program.

G. Ineffective and flawed program rules.

1. *CHCF-B pays subsidies even if carriers earn more than market based rates of return*

Unlike the CHCF-A for small cost-of-service regulated incumbent carriers serving areas where competition is not yet authorized, the CHCF-B program pays subsidies to carriers even if carriers' profits exceed their "market based rates of return"[72]. Thus, the CHCF-B may enhance a carrier's profits without stimulating increased access to telephone service in rural or other high cost areas.

2. *The CHCF-B program does not require carriers to spend subsidies on California telecommunications networks.*

The program does not require carriers to spend subsidies on California's telecommunications networks. Thus, for example, while California's largest carrier has cut thousands of jobs in California in recent years, it has at the same

[70] 68 CPUC 2nd, p.593.

[71] Ibid, p.683.

[72] The market based rate of return for a NRF telephone carrier is supposed to be comparable to what would have been an authorized rate of return under traditional regulation.

time increased its CHCF-B subsidy claims. Importantly, in justifying its job reductions in California, Pacific asserts that its workforce is more efficient, in effect, confirming that its costs have declined.[73]

H. A comprehensive review of the CHCF-B program has never been done.

While some audits of individual carriers have been done in the last couple of years[74], there has never been a comprehensive review of the entire CHCF-B program. Such a review would produce a better understanding of how hundreds of millions of dollars of ratepayer funds are being expended. ORA believes a program-wide, comprehensive review should be done promptly, and periodically, because Commission rules require carriers to retain certification documents for only 36 months.[75]

I. Carriers continue receiving CHCF-B while increasing rates previously reduced to offset CHCF-B subsidies.

Because the Commission hoped that most telecommunications services would face widespread competition and that this competition would lead to lower prices, the Commission did not anticipate that rates might actually *increase* for services deemed "competitive" but not in fact facing effective competition. However, subsequent to the Commission's action reducing rates to remove implicit subsidies from services, carriers have effectively increased rates for some services allegedly, but not actually, facing effective competition.

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[73] See I.02-11-008 (Investigation into Pacific's announced job reductions).

[74] Audits of CHCF-B claims:

- *Final Report, Attestation Exam of Pacific Bell Telephone Company's CHCF-B Claims 1997 – 2001,* by Vantage Consulting, July 28, 2003.
- *Attestation Examination of Roseville Telephone Company, Inc. (Roseville's) CHCF-B Claims, 1997 – 2001,* by Vantage Consulting, March 27, 2003.
- *Final Report, Audit of Citizens Telecommunications Company of California's CHCF-B Claims for the California Public Utilities Commission Telecommunications Division,* 1997 – 2000, November 2000.

Audits of Surcharges:

- *Final Report: Attestation Examination of Pacific Bell's Assessment, Collection, Reporting, and Remittance of the CHCF-B Surcharge and the CTF Surcharge Revenues*, 1997 - 2000. March 25, 2002.

[75] Resolution T-16018, Finding No. 9.

For example, in 1999, the Commission approved Pacific's application to increase Local Directory Assistance (DA) charges to $0.46 per call and reduce the monthly free call allowance for residential customers from five (5) to three (3).[76] Thus, Pacific has been able to reduce the amount of DA service included in residential basic service and increase rates for those services already paid for in part through the CHCF-B, while continuing to receive full CHCF-B subsidies[77], effectively increasing its overall revenues.

Importantly, Pacific sought to gain even greater pricing flexibility for Local DA[78] and, if the Commission approves Pacific's request, ORA expects additional rate increases similar to those in other Pacific states where a call to directory assistance costs customers $1.50, and elimination of the remaining residential call allowance of 3 free DA calls per month. When considering carrier rate increases or pricing flexibility/recategorization requests, the CPUC should account for (and offset) the subsidies the carriers are recovering under the CHCF-B program in order to prevent a windfall to the ILECs.

VI. Recommendations

A. Data Tracking

Decision makers need timely and relevant data in order to review the efficacy of the CHCF-B programs. ORA's concerns were well articulated by the CHCF-B Advisory Committee in its 2003 Annual Report (pg.5):

> The Telecommunications Division of the CPUC should keep current electronic books showing the monthly claims for each carrier, and any later adjustments to those claims, for current and all previous years (the PUC should also consider instituting a 2 year limit on making adjustments to claims).[79] This database should also include the number of lines claimed as well as the number of subsidized lines. It need not be disaggregated down to the CBG level, but should show county data, i.e. the number of lines claimed in each county and the total subsidy claimed

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76 D.99-11-051. Subsequently, Pacific's Directory Assistance revenues increased from $[redacted] million in 1999 to approximately $[redacted] million in 2000, an increase of $[redacted] million.

77 Pacific's $305 million subsidy anticipated in 1997 included almost $60 million for DA functions included in basic service.

78 Application 02-07-050. As of the issuance of this report, a motion for withdrawal has been filed. This motion is pending.

79 It is ORA's understanding that some carriers are filing adjustments to claims three and four years after the original claim was filed.

in that county. The CPUC should compile this detailed programmatic information into a report on an annual basis.

Providing the underlying tables by county will enable decision-makers to more easily determine the areas of the state being subsidized and assess program effectiveness. The last 5 years should be included in the report so as to capture any adjustments to prior years' claims by the carriers.

Resolution T-16430[80] states that, "TD staff have been reviewing claims from carriers for years 1997 through 1999 and January 2000. All carriers have been resubmitting their claims for years 1997 through 1999 because of errors or lack of supporting documents for primary line designations, and other reasons. Certain carriers have re-submitted more than twice to support their 1997 through 1999 claims. One carrier submitted its 'final' monthly claims for 1997 and 1998 on April 12, 2000."

ORA also recommends extending the record retention requirement to ensure data is available for an audit or during a periodic review of program operations.

B. Increase Administrative Resources

The CHCF-B budget for Fiscal Year (FY) 2003 – 2004 sets aside only $103,000 for administrative staff, which is below one-tenth of 1% of program cost.[81] While minimizing administrative overhead is desirable, it should not be done to the detriment of responsible management. The administrative budget should be comparable to other similar subsidy programs, and be large enough to ensure timely payment and complete tracking of carrier claims and annual reports on fund operations.

Increasing the Commission staff resources to oversee the administration of the CHCF-B program would be a cost effective use of program funds. In the current FY budget, $1 million is budgeted for interest payments to carriers for claims that are paid late due to Commission staffing resource constraints. And since January 1, 1999, $8 million has been budgeted for interest on late claim payments.[82] Spending more on administrative resources would surely save the CHCF-B program millions of dollars in interest payments.

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[80] Resolution T-16430, September 21, 2000, Footnote 7.

[81] Resolution T-16690.

[82] Resolution T-16244, December 3, 1998, pg. 3. "… and $2.0 million for estimated interest payments to carriers for claims not approved in a timely manner by the CHCF-B AC due to the limitation of staff

C. Immediately conduct a comprehensive program review and recalibrate CBG costs

A programmatic review can be a powerful tool to identify problems and weaknesses in the current CHCF-B program. Statewide average and CBG costs should be reviewed and recalibrated.

ORA believes that the UNE costs being developed in the Open Access and Network Architecture Development (OANAD) proceeding could provide a reasonable basis upon which to establish current estimates of CHCF-B statewide average and CBG-specific costs. ORA urges the Commission to consider using the soon-to-be-adopted UNE costs to determine the cost of serving high cost areas.

D. Implement a program feature that will phase out subsidies

It appears that carriers may be receiving a windfall from the CHCF-B program. It makes no sense for a carrier that earns a 20% rate of return to be drawing subsidies from the CHCF-B. Subsidies should be cost justified or phased out.

The Commission should add a feature to the program that phases out subsidies that are not cost justified and that enhance profits at or above *market based* rates of return. For example, Verizon drew [redacted] from CHCF-B in FY 2001-2002 while posting a rate of return of over 20% in 2002.[83] Use of a "means test" would prevent carriers from receiving unwarranted subsidies. This approach could be adapted from the one used for carriers participating in the CHCF-A program.[84] For carriers earning above the market-based rate of return, this could be done by:

1) Systematically reducing the available subsidies to carriers over time, until a periodic review of the program is triggered (i.e., apply a "waterfall" provision like that used by the CHCF-A program).

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resources in the Telecommunications Division." Subsequent budgets annotate the interest payments to carriers with a footnote that says, "D.98-01-023 ordered that interest be paid to carriers for claims that are not processed within the time prescribed."

[83] Resolution T-16773, October 30, 2003.

[84] D.88-07-022, D.90-12-080, and D.91-05-016.

2) Requiring carriers seeking to draw from the fund to show that their cost structure justifies the subsidy payments. This could be done by means of a rate review.[85]
3) Offsetting subsidy payments on a dollar-for-dollar basis for each dollar a carrier exceeds the market-based rate of return.[86]

<END>

[85] Inasmuch as the Commission neither examines CLEC costs, nor sets CLEC rates, it may be appropriate to exempt the CLECs from this kind of rate review.

[86] The Commission could use the incumbent's authorized ROR as a surrogate for CLECs drawing from the CHCF or exempt them entirely from such offsets.

VII. Appendices

A. Legislative history.

Originally, Public Utilities Code Section 739.3 required the Commission to develop, implement, and maintain a suitable program to establish a fair and equitable local rate structure aided by transfer payments to small independent companies serving rural and small metropolitan areas.

In 1994, the Legislature passed AB 3643, which required the Commission to examine the current and future definitions of universal service, including how universal service should work in the new and increasingly competitive markets. Then, in September 1996, the Legislature passed SB 207 which amended PU Code Section 739.3 to develop a competitively neutral, broad-based program to help ensure that telephone service is widely available and affordable under local competition, and required the Commission to report on the effectiveness of its universal service programs. The stated purpose of the program was to promote the goals of universal telephone service and to reduce any disparity in the rates charged by those companies

In 1999, the Legislature created the California High-Cost Fund-B Administrative Committee Fund within the State Treasury[87] The legislation further provided that the funding would be in rates, while the funds collection would be submitted first to the Commission, and then deposited with the Controller for deposit in the California High-Cost Fund-B Administrative Committee Fund.[88] The same legislation also required periodic audits, on at least a three-year basis.

Section 20 of SB742 (2001) allowed funds to be transferred between various telephone funds in the annual budget act. In 2001, the Legislature passed legislation demonstrating its concern with the stale data underlying CHCF-B. Section 270 (b) restricted the transfer of B funds until the service costs from the Commission's 1996 decision are recalculated.[89] The Budget Act of 2002 (AB425) transferred $250 million of High Cost Fund-B money to the state general fund.[90]

In AB 140 (Statutes of 2001), the Legislature restricted fund transfers from CHCF-B to the other high cost fund until statewide data was recalculated.

B. Enabling Legislation. (Section 739.3c)

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[87] Section 270(a)(2) of the Government Code, pursuant to SB 669.

[88] Government Code section 276(b).

[89] Public Utilities Code Section 270(b)(2).

[90] Provision 8660-011-047.0.

739.3. (a) The commission shall develop, implement, and maintain a suitable program to establish a fair and equitable local rate structure aided by transfer payments to small independent telephone corporations serving rural and small metropolitan areas. The purpose of the program shall be to promote the goals of universal telephone service and to reduce any disparity in the rates charged by those companies.

(b) For purposes of this section, small independent telephone corporations means those independent telephone corporations serving rural areas, as determined by the commission.

(c) The commission shall develop, implement, and maintain a suitable, competitively neutral, and broad based program to establish a fair and equitable local rate support structure aided by transfer payments to telephone corporations serving areas where the cost of providing services exceeds rates charged by providers, as determined by the commission. The commission shall develop and implement the program on or before October 1, 1996. The purpose of the program shall be to promote the goals of universal telephone service and to reduce any disparity in the rates charged by those companies. The commission shall structure the program required by this subdivision so that the amount of each transfer payment reasonably equals the value of the benefits of universal service to the transferor entity and its subscribers. Except as otherwise explicitly provided, this subdivision does not limit the manner in which the commission collects and disburses funds, and does not limit the manner in which it may include or exclude the revenue of transferring entities in structuring the program.

(d) The commission shall investigate subsidy reduction, or elimination of subsidies in service areas with demonstrated competition.

(e) Not later than February 1, 2001, the Legislative Analyst shall conduct a review of the state's universal telephone service program, including subsequent modifications as appropriate, and report to the Governor and the Legislature as part of the Legislative Analyst's analysis of the Budget Bill to be issued in February 2001. In evaluating the program, the Legislative Analyst shall consider all of the following:

(1) The findings of the report required by subdivision (e).

(2) An assessment of whether any identified problems are issues that affect the continued implementation of this chapter or issues that warrant revisions of statutes or regulations.

(f) This section shall remain in effect until January 1, 2005, and as of that date is repealed, unless a later enacted statute, which becomes effective on or before January 1, 2005, deletes or extends that date.

C. California High Cost Fund-B (CHCF-B) Program History (from CPUC website)[91]

- **Public Utilities Code Section § 739.3** required the California Public Utilities Commission to develop, implement, and maintain a suitable program to establish a fair and equitable local rate structure aided by transfer payments to small independent companies serving rural and small metropolitan areas.

- **Decision (D.) 96-10-066** established The California High Cost Fund-B (CHCF-B) program to provide universal service subsidies in high cost areas of the service territories of Pacific, Verizon of California (Verizon), Verizon of California – Contel (Contel), RosevilleTelephone Company (Roseville),and Citizens Telecommunications Company of California (Citizens).

- **An all-end-user surcharge** billed and collected by telecommunications carriers which, in turn, remit the surcharge monies to a financial institution as directed by the Commission or its representatives, funds the CHCF-B.

- The Commission set-up a Committee consisting of three Commission staff members appointed by the Executive Director plus one non-voting liaison appointed by the Director of the Telecommunications Division.

- **D. 98-06-065** adopted the governance and operations of the CHCF-B Administrative Committee (AC). The Administrative Committee conducts its business in public meetings, held usually once a month discussing and reviewing claims submitted by the carriers, other monthly expenses, and the projected financial status of the CHCF-B fund.

- **D.98-06-065** renamed the committee as CHCF-B AC and revised the governance of the CHCF-B consistent with State rules and procedures.

- **Annual Budgets** for the CHCF-B program are adopted by the Commission through the resolution process. Budget resolutions can be found at: http://www.cpuc.ca.gov/static/industry/telco/consumer+information/surcharges+and+taxes/index.htm.

- **PU Code § 270-281** et seq. were codified by the enactment of SB 669 (1999) requiring a CHCF-B Trust Administrative Committee Fund be created in the State Treasury, required that monies in the fund may only be expended for the program and upon appropriation in the annual Budget Act, and changed the role of the CHCF-BAC from administrative to advisory.

- **SB 742** (2001) mandated that the remaining funds of the CHCF-B Trust be transferred to the State Treasury on October 1, 2001.

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91 From CHCF-B Orientation Packet, March 20, 2003. Posted on CPUC website at www.cpuc.ca.gov

- **D.01-09-064** revised the charter of CHCF-B AC to conform to SB 669, and directed the Information and Management Services Division (IMSD) and the Telecommunications Division (TD) to take over the administration of the CHCF-B program starting October 1, 2001.
- **D.02-04-059** established a five-member board for the CHCF-B AC. On September 13, 2002, the Commission issued a letter on the advisory committee application process. This letter was sent to over 4,000 groups and organizations. Interested parties were requested to submit their resumes to the Commission on or before October 31, 2002.
- On January 14, 2003, the Executive Director appointed five (5) members and their alternates to the CHCF-B AC.